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**Encouragement of consumption is no benefit to commerce, for the difficulty lies in supplying the means, not in stimulating the desire of consumption; and we have seen that production alone furnishes those means. Thus, it is the aim of good government to stimulate production, of bad government to encourage consumption.**

**Jean-Baptiste Say, *A Treatise on Political Economy*, 1803**

## BUBBLE AFTERMATH

Since World War II, all recessions in the United States, as well as in the rest of the world, had their main cause in monetary tightening by the central bank, implemented in response to rising inflation rates. As soon as the central banks loosened their shackles, the economies promptly took off again. Also important, the business cycles in America and Europe never used to coincide and cumulate, but instead used to follow each other. The fortunate effect of this regular sequence was that it stabilized the world economy.

For the first time in the whole postwar period, the U.S. economy has slumped against a backdrop of the most aggressive rate cuts by the Federal Reserve and the most rampant money and credit growth ever. Implicitly, the forces depressing the U.S. economy this time are radically different from those that fueled past recessions. It is the goal of this letter to explore and identify the unusual causes of this economic downturn.

Among these causes, the profit implosion is the most obvious and also the most important. Essentially, it must have its own specific causes. Searching for them, we identified three major profit killers: first, a surging share of depreciation charges in gross investment; second, inflexible, record-high interest charges; and third, the gaping trade deficit. Widespread hopes of an early rebound in U.S. corporate earnings are doomed.

But there is another crucial novelty to this economic downturn. That is its global synchronization. The problem is that the global economic upturn of the past few years was equally synchronized, as economies around the world adjusted to the roaring U.S. asset and spending bubble. During 1997–2001, American spending on imported goods and services exceeded earnings from exports by altogether \$1,428.8 billion. To put this into perspective, U.S. GDP growth during these four years was \$1,055 billion in real terms and \$1,763.8 billion in nominal terms.

It is a familiar postulate of Austrian theory that the extent of the bust following a boom tends to be rather proportional to the scope of the excesses and the adherent economic and financial imbalances that accumulated during the boom. Gottfried Haberler's *Prosperity and Depression* (1937) says, "*The length and severity of depressions depend partly on the magnitude of the 'real' maladjustments which developed during the preceding boom and partly on aggravating monetary and credit factors.*"

This postulate of the proportionality between boom and bust has convinced us from earliest times. Manifestly, it is diametrically opposite to conventional thinking in America that, under the influence of Milton Friedman, discards past boom excesses as things of the past. Past is past, and the only thing that counts for the present and the future is current monetary policy.

In this view, the Depression of the 1930s owed nothing to any credit excesses and related maladjustments in the economy and the financial system during the boom years, but resulted exclusively from the Fed's flawed policies after the stock market crash. Common to this opinion is furthermore the conviction that proper monetary policy is capable under all circumstances of preventing recession and depression.

## IT IS WORSE THAN IT LOOKS

It goes without saying that this kind of thinking is prone to foster illusions about what monetary policy can do. What we generally hear and read from American sources reveals that there is, in fact, a widespread, inordinate complacency about the U.S. economy's woes, even though troubling economic data abound lately. A strong, preconceived view appears to hold sway that everything is bound to come up roses in the end.

We stick to our view that the world economic prospects are significantly more bleak than most people realize. The existing imbalances and structural distortions are too big and the room to cut interests far too small to fight the spreading weakness. But as to prevailing illusions, America is apparently on top. The rest of the world clearly lacks the dynamics for self-made economic growth. But Europe, above all, has no prior excesses to cope with. Our particular concern about the U.S. economy arises from the recognition that the world's greatest bubble in history has in many ways grossly imbalanced it, hampering growth for a long time to come.

The decline of profits is already the worst since the 1930s. What's more, it started long before the economy began to slow down. Yet it is not alone in depressing the U.S. economy. Strong, correlative depressants are those maladjustments that Austrian theory puts at the center of its investigations, but which American economists in general completely ignore.

Measured as a share of GDP, profits before tax of the corporations in the nonfinancial sector are already well below their level during the recession in the early 1990s. There was an uptick in early 2002, but for reasons explained, the trend remains downward.

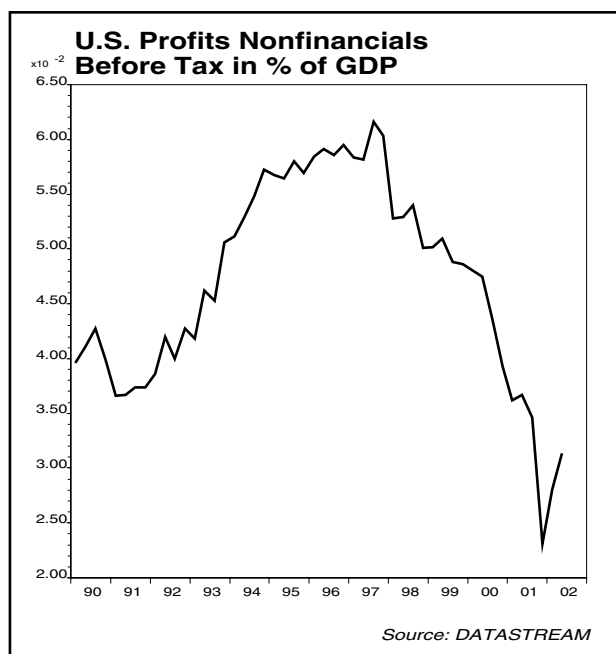
The popular, optimistic spin persistently coming out of Washington and Wall Street always ends up with the vacuous claim that the economy's *"fundamentals have never been sounder."* However, they have very funny ideas of what actually represents an economy's crucial growth fundamentals. Low inflation rates and a high rate of productivity growth appear to enjoy their highest esteem.

That's truly new economics. For the old economists, and in the same vein for us, low inflation rates are nothing to brag about. They are one of various obligatory conditions that are needed for healthy economic growth. And as for the miraculous productivity growth, we have explained many times that in the U.S. case it reflects more statistical than economic magic.

For the old economists, and just the same for us, healthy, long-term economic growth depends primarily and crucially on adequate national saving and net investment, making for capital formation and increasing the productive capital stock. It may always be arguable which rates are adequate, but the obvious thing to see about the U.S. economy is that its savings and investment performance in the past few years has been most miserable.

There is a lot of talk nowadays about the need for economic restructuring in other countries to compete with the U.S. economy. It is true that the latter has been massively restructured. Unfortunately, it was a kind of restructuring that generations of economists would have dismissed as utterly destructive for future economic growth.

The U.S. economy's macroeconomic "restructuring" in the past several years had four interrelated components. Its decisive, primary force was an unprecedented consumer borrowing and spending binge that sent personal consumption to its highest level ever as a share of GDP. This had three directly related counterparts in the economy: (1) sharply lower personal saving; (2) sharply lower net business investment; and (3) an exploding trade deficit. From a macroeconomic perspective, and considering also the scope of these imbalances, this was outright murder of the economy's supply side.



## **NO SIGN OF A SUSTAINABLE RECOVERY**

Fostered by Anglo-American reporting, there is a general impression that the U.S. economy is performing better than the economies in the rest of the world. In the second quarter of 2002, U.S. real GDP was up over the year by 2.2%, as against 0.6% for the euro area and -0.7% for Japan. This pales, though, in comparison to the growth rates of most developing countries, showing increases of 3–4% and much higher against a year ago.

It amazed us how quickly and uncritically the consensus instantly grabbed the positive GDP numbers as convincing evidence of a beginning U.S. economic recovery. On closer look, the recorded GDP growth plainly lacked any self-sustaining and self-reinforcing dynamics.

The spurt in consumer spending had manifestly unsustainable causes.

As we have always emphasized, the American boom of the past few years was in reality not reflecting a technology investment boom, but the greatest consumer borrowing and spending binge of all times, propelled by the skyrocketing stock prices that were believed to make saving from current income superfluous.

## **THE LAST THREE BUBBLES**

In the face of slumping stock prices, the new consumer borrowing and spending binge received its most recent impetus from the coincidence of three events: (1) a surge in house prices, (2) a sharp fall in mortgage rates, and (3) very aggressive lending activity by the mortgage system. It delivered another temporary boost to GDP growth, but this boost was definitely not qualified to sow the seeds for sustained, self-reinforcing recovery.

Was it another bubble? Of course it was. On closer look, it resulted from a sequence of three bubbles — first, the Treasury bond bubble; second, the house bubble; and third, the consumer borrowing and spending bubble. Bubbles always derive, in essence, from borrowing and lending excesses. Considering America's gross lack of genuine savings, it was plainly obvious that the sudden sharp slide of Treasury yields and in its wake of mortgage rates could only stem from an explosion of heavily leveraged yield-curve playing. Given the low inflation rates and abounding signs of a weakening economy, it seemed a very safe speculative bet.

Everybody liked the stimulus that this new bubble gave the economy. On closer look, it was in reality grossly ill-structured growth. First of all, so-called wealth creation through inflating stock or house prices is in essence a great delusion. If these prices rise all around, there is no individual gain. What's more, from the macroeconomic perspective, it is phantom wealth that impoverishes a nation if it boosts consumption at the expense of domestic capital investment and the foreign balance.

Even more preposterous is the way this wealth creation effectively comes about — that is, through the conventional practice to capitalize the whole stock of outstanding stocks or existing houses at the prices of the last marginal trade. Statistically, this is a harmless exercise, unless the financial system uses these lofty marginal market valuations as its measure for ever higher lending.

## **CYCLICAL VERSUS STRUCTURAL**

What then, apart from the profits carnage, is relentlessly driving the U.S. economy into recession? Putting it first into various colloquial commonplaces: It is a plethora of unsustainable, structural maladjustments, imbalances, distortions or dislocations. The emphasis is on the words *unsustainable* and *structural*. Any change tends to become structural when it lasts long enough to impact existing structures.

But appraising the extent of structural maladjustments, distortions or dislocations first of all requires, of course, a concept of economic balance. This, in fact, used to be the starting point for all economic thinking. Put succinctly: a fundamentally balanced economy is one where the pattern of demand growth corresponds with the economy's established output pattern. If the two significantly diverge for a prolonged period, there will be trouble in the future.

The things to be kept in balance in an economy and its financial system are many: overall supply and overall demand; prices, costs and profits; saving and investment, and also saving and credit expansion, to mention just a few.

*One of the central problems of economic policy is the allocation of resources between consumption in the present and capital accumulation for the future. The division between the two sectors is primarily determined by the savings rate of the consumer. Available savings, being defined as current income not spent for consumption, make the real and financial resources available that can be used to produce plant and equipment and other components of the capital stock.*

It is an established, historical fact that over time individual economies develop a production structure that reflects its long-term demand structure. High-savings countries typically have high rates of capital investment and in line with it large capital goods industries. The opposite pattern holds true for the production structure of countries with low-savings ratios. Also typically, such established patterns change only moderately over time.

Business cycles are in their very nature departures from economic balance. Credit excesses inherently disrupt established patterns of demand and production. Recessions develop as consumers and businesses strive to return to their desired and sustainable long-term pattern of spending, saving and investing. Essentially, the recession's length and severity depends on the scale of unsustainable distortions that the credit excesses during the boom have inflicted on the economy's demand and output structure, and that have to be readjusted.

The dominating component of the postwar business cycles were inventory fluctuations, associated with minor excesses in building and business investment. Necessary readjustments, fueling the following recessions, caused little pain and were rather quickly accomplished. The U.S. recession of the early 1990s was the first one that deviated from this pattern with stronger building excesses and major financial difficulties.

By international comparison, America had already been a low-savings and low-investment country since the 1920s. They invented consumer installment credit back then. After World War II the household savings rate had been hovering around 8% of disposable income. But this rate began a slow decline in the late 1980s, plunging steeply after 1997. In 2000, it hit almost zero. This compares with recent household savings ratios of 10–11% of disposable income in Japan, Germany, Italy, Spain and the Netherlands. An exception with a much higher rate is France.

### **INFLECTION POINT 1997**

The obvious primary reason why personal saving in the United States plummeted as never before after 1997 were the soaring wealth effects of the greatest bull stock market in history. Reflected in the collapsing personal saving, personal consumption shot up to 90% of GDP. This compares with a share of 71% in the 1980s. In current dollars, personal consumption's share of the GDP soared from 68% to 82%.

It should be clear that this represented a savage break in the U.S. economy's demand pattern. But as it was operating virtually at full capacity utilization, the jump in consumer spending translated overwhelmingly into the exploding trade and current account deficit and to a lesser extent into lower net investment.

The annual current account deficit surged from \$128.4 billion in 1997 to lately \$450 billion. Put differently, the explosion in consumer spending mainly benefited foreign producers. Though this prevented inflation in the United States, it was hardly a desirable achievement.

What was wrong with this consumer spending bubble? Focusing exclusively on the low inflation rate, Fed Chairman Greenspan and the American consensus saw nothing wrong in this development. They took no notice of the tremendous damages that were being done to domestic saving, capital formation and profits.

On reasonable reflection, it was perfectly clear right from the beginning that all these unfolding distortions in the economy were very undesirable and unsustainable. What's more, these distortions were plainly of a size that would later warrant prolonged and painful adjustment processes. After all, confronted with shattered stock market wealth, the consumer is bound to resume his old-fashioned saving from current income. Doing so, he will finally pull the rug from under the economy. Actually, being robbed of his stock market wealth, his need to save for retirement will be greater than ever. The rising personal savings rate will be the death sentence for the U.S. economy's growth for years to come.

*The crucial point to recognize is that such structural distortions, accruing from the credit excesses, are the decisive, malicious legacy of a bubble economy, strangling economic growth through various pervasive effects.*

### **RECOGNIZING A BUBBLE**

In his Jackson Hole, Wyo., speech, Mr. Greenspan reiterated his familiar viewpoint that it is difficult to definitely identify a bubble until after the fact — that is, when its bursting confirms its existence. Rubbish. The bubble was as apparent to everybody as the emperor without clothes. The only thing needed to see and say the obvious was integrity and honesty among policymakers and economists. By many measures, it was a bubble that had grown to unusual extremes.

A recently published study by the Bank for International Settlement in Basel about the nexus between asset prices and monetary and financial stability draws the conclusion, among others, that more and better data and more and better empirical research is needed to identify the conditions that increase the likelihood of financial strains. We think this is far too polite a supposition to make. The relevant figures to identify the U.S. bubble were available in overabundance for years. What prevented policymakers and economists from saying so was one of two things: either lack of the necessary knowledge or lack of integrity.

*What are the key features of a developing bubble economy? First of all, exploding money and credit growth; and second, major diversions in the economy's growth pattern.*

Both features, actually, showed flagrantly in the United States. The surge of consumption as a share of GDP and the correlated collapse of personal saving were strikingly documented and easily recognizable. Not only that, but it was also common knowledge and openly discussed that this consumption boom was getting its particular impetus from exploding stock market wealth.

As explained, such distorted demand stimulation through rising asset prices is precisely the malicious key characteristic of a bubble economy. But American policymakers and economists ignored this distortion and focused stereotypically on the strong, aggregate GDP growth, hailing it as a new virtuous circle in which thriving financial wealth is driving economic growth.

No less compelling evidence came from the bursting credit money and credit numbers. Both accelerated at unprecedented speed. Broad money (M3), up \$500 billion during the first half of the decade, shot up during the second half to five times that amount — \$2,500 billion. Again, far from raising any concern, this unfolding money and credit deluge generally extricated favorable comments that this was positive for the stock market.

Studying monetary and financial developments, we prefer to focus on credit and debt growth. Sharply accelerating debt growth is the other malicious feature of bubble economies, as the inflating asset prices provide rapidly rising credit collateral. Comparing the rocket-like debt growth over the past few years in the United States with the dismal performance of incomes, business profits and asset values, we have no doubts about a

UNITED STATES: DEBT GROWTH BY SECTORS (IN \$BILLION)					
	FEDERAL GOVERNMENT	CONSUMER	BUSINESS	FINANCIAL SECTOR	TOTAL
1996	144.9	343.8	251.6	550.1	1,290.4
1997	23.1	332.7	392.8	662.2	1,410.8
1998	-52.6	454.4	560.8	1,087.2	2,049.8
1999	-71.2	501.6	586.6	1,084.4	2,056.4
2000	-295.9	545.9	584.6	815.6	1,686.2
2001	-5.6	614.6	391.4	929.3	1,929.7
2002 I*	112.0	695.8	127.4	933.3	1,686.5
2002 II*	451.3	705.5	201.1	916.3	2,274.2

\* figures for the two quarters are annualized

Source: Federal Reserve Flows of Funds

looming, pervasive debt crisis.

Does the Fed have any measure for credit excess? The governing principal idea seems to be that a low inflation rate prohibits any credit restraint. It is a popular view, but it lacks any economic reason. As inflation rates are subject to many different influences, they can't be given a controlling role in monetary policy.

### **AN OUTSIZED CREDIT MACHINE**

In classical economics, noninflationary credit has its strict limit in available savings from current income. The underlying concept is that such saving releases real resources that the credit transfers to some borrower who uses them for his chosen purposes. In a balanced economy, new credit equals new saving.

We mentioned this apparently purely theoretical point because it reveals something very important about the U.S. economy. First, though, the numbers: In 2001, net savings of consumers and businesses (undistributed profits) amounted to \$330 billion, or about 3% of GDP. This compared with overall credit and debt growth of almost \$2,000 billion, or roughly 20% of GDP.

*Basically, saving is unspent income. Credit creates spending power out of nothing. These two observations point to America's true growth engine: a grossly outsized credit machine, pouring persistently unlimited amounts of credit into the economy and its financial markets, as against almost nonexistent domestic saving.*

Since each dollar added to credit is a dollar added to somebody's indebtedness, this credit/debt explosion, too, might have deserved some attention, at least on the part of the Federal Reserve. What's more, this credit machine is overwhelmingly geared to finance consumption and financial speculation. Very little of its lending goes into capital formation. But in a country with very low savings, investment has its narrow limits anyhow.

### **PERVASIVE DISTORTIONS**

It is our declared goal to explore in this letter those so-called imbalances, distortions and dislocations that act as the U.S. economy's main depressants. They actually pervade the whole economy in many ways, essentially also impacting and distorting profits. Here are the pure profit numbers.

CORPORATE PROFITS BY INDUSTRY GROUPS (\$BILLIONS)								
	1997	1998	1999	2000	2001	I	II	I
Manufacturing	195.2	164.3	157.5	159.8	83.4	91.5	50.9	68.9
Durable goods	94.0	80.7	68.2	61.5	9.9	11.6	-14.9	2.5
Industrial machinery	16.3	16.1	7.2	14.2	-0.6	-5.2	-7.5	-4.9
Motor vehicles	4.0	5.2	6.3	-2.2	-9.4	-6.4	-13.3	-11.4
Electronic and other								
Electrical equipment	22.8	7.6	3.4	5.5	-3.2	-4.6	-8.4	-6.2
Nondurable goods	101.2	83.8	89.3	98.3	73.5	79.5	65.8	66.4
Wholesale trade	49.2	55.9	54.4	62.1	44.8	45.9	46.9	41.2
Retail trade	63.9	73.8	75.6	73.4	79.1	82.6	80.5	81.4

*Source: Survey of Current Business, Table 6.16C, Corporate Profits by Industry Group*

The table reveals extreme changes in the corporate profit pattern. Not surprisingly, they precisely accord with the described drastic changes in the economy's demand pattern. Manufacturing stands out as the great loser.

Yet within the sector, it is specifically the profits of the durable goods producers that have been literally hammered.

Exposure to foreign competition is one obvious reason. But the unusually poor profit performance of the producers of durable goods has its specific, additional reason in the sharp decline in business investment spending. For obvious reasons, retail trade is the great beneficiary. It is a reasonable assumption that this grossly distorted profit pattern entailed a correspondingly distorted investment pattern.

### **WHAT DEFLATION?**

The new catchword in the discussion about the global economy in general and the U.S. economy in particular is deflation. It is a loaded word, especially in the United States, conjuring up images of the Great Depression in the 1930s and, more recently, of Japan's decade-long slump.

Deflation is generally perceived as a persistent decline of the price level, just as inflation is perceived as a persistent rise of the price level. Intrinsic to this notion is that both are pure monetary phenomena in the sense that they reflect mainly, or solely, flawed monetary policies.

In the same vein, there is a widespread belief that both price diseases are promptly curable by appropriate monetary policies. For the American consensus, Japan owes its economic misery simply to insufficient monetary easing. What that ease ought to look like, given that Japan has already had near-zero interest rates for years, remains unexplained. For the idea that a central bank might be "*pushing on a string*," most American economists have only flat denial.

But the United States is presently experiencing something that has no precedent in economic and monetary history. The famous deflation of the 1930s occurred, rather plausibly, in connection with collapsing money and credit growth. America's present experience, however, is unique in that the low and declining inflation rates coincide with rampant money and credit growth.

The compelling conclusion is that the profit implosion cannot have monetary causes. Its effective causes are, essentially, the same ones that are depressing the economy; that is, those structural distortions and dislocations that we have described. Then talk of deflation only tends to distract from the true causes.

As to the relevant facts, we once again stress that this dismal profit performance effectively started in 1997, while the economy was still booming and prices were far from being depressed. During the following three years, industrial production rose overall by 16.6% with overall productivity growth of 9%. Consumer price inflation was between 2–3%. Under these conditions, business profits ought to have soared.

It is widely recognized by now that a self-sustaining and self-reinforcing economic recovery in the United States depends crucially on a drastic reversal both in the profit performance and in business capital spending. Forestalling the conclusions from the following analysis of profit implications, our answer to this question is:

***There is nothing in sight that might improve U.S. corporate profitability and thus stimulate business capital investment. Many signs suggest the opposite.***

### **TRACING THE CAUSES OF THE PROFIT MISERY**

By no means is it mere guessing that leads us to this gloomy forecast. It is grounded in the systematic analysis of the specific macroeconomic measures and flows of funds that determine the level of overall profits.

In the capitalistic world, economic activity is ruled by profit prospects. Long ago, John Maynard Keynes wrote: "*The margin which the business man requires as his incentive to produce may be a very small proportion of the total value of product, but take this away from him and the whole process stops.*"

Considering the key role of profits in shaping economic activity, it is puzzling how little attention this exceptional profit carnage is finding. After all, deflation is now the general explanation. Even deflation, though, must essentially have specific causes. It doesn't happen just by itself, least of all in the face of the most rampant money and credit growth in history.

Amazingly, the profit generation process has always been a highly neglected theme in economics. That is probably because economists always tended to view profit fluctuations as little more than symptoms of the business cycle's fluctuations. Accordingly, research concentrated on the business cycle, all but ignoring the question of specific influences on profits.

This was OK as long as the cycles were of the garden-variety type, mainly involving brief inventory liquidations and also brief and modest profit fluctuations in their wake. But this time, everything is extremely different. This downturn of the U.S. economy is strikingly led by a profit and capital spending crisis of extraordinary severity. But in order to assess prospective changes, it obviously needs some idea about underlying causes in the first place.

### **THREE MAJOR PROFIT KILLERS**

Profits are produced by specific macroeconomic flows of funds. Our focus is on the measures and influences that determine aggregate corporate profits. The crucial point to see here is that many measures that individual firms take to improve the profits of their own firm have the opposite effect on aggregate profits because they reduce the revenues of other firms. The obvious examples are all kinds of corporate cost cutting.

Actually, there was one renowned economist who explored and explained the profit generation process. That was Keynes. The decisive new point that he made in a paper published in 1931 was that business revenues are subject to two different streams of money: consumer spending and business spending on investment. *"Now the profitability of business as a whole depends, and can depend, on nothing but the difference between the sale proceeds of the entrepreneurs and their costs of production."*

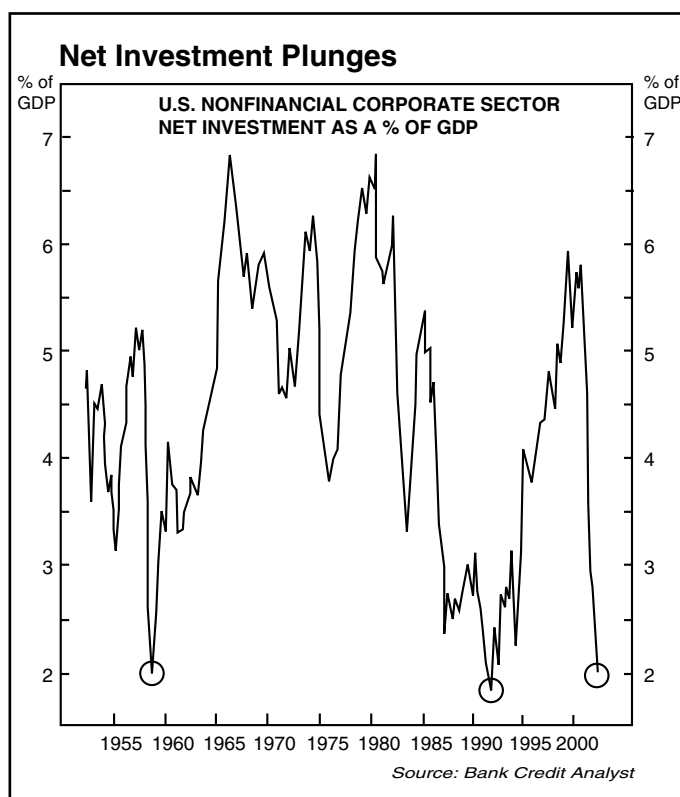
In a further remark, he pinpointed the key role of business capital spending in the profit generation process, as follows: *"The overall costs of production are equal to what the public earns through wages, salaries, rents and interest, but business receipts are equal to what the public spends **plus** the value of current investment."*

This is really the all-important point about profit creation. Business revenues accrue not only from consumer spending but also from business spending. Among the latter, moreover, one kind is crucial for the profit creation process because it creates business revenue without creating business expenses, and that's business capital spending.

When a firm builds a new factory or installs new machinery, no expenses are incurred because these expenditures are capitalized. Expenses arise later and gradually with the depreciation charges. For the producers and sellers of the capital goods, though, it produces immediate revenue.

### **...SOARING DEPRECIATION DRAIN**

Looking at economies as a whole, growth in business net investment normally represents the single largest profit source. But this profit source in the United States has been running rather dry in the past few years. Its most important reason was a growing wedge between gross and net investment, due to the fact that the growth in depreciation charges overtook the growth in gross investment. In essence, this reflected a drastic shift in corporate capital investment away from traditional longer-lived plant and machinery and towards very short-lived equipment of the new information technology, such as



computers and software.

As depreciation charges represent an expense for corporations, this inherently drained profits. To give an idea of its impact, in 1997 the ratio of capital consumption to new, gross fixed investment was 57%; in 2001, it was 67%. In other words, two-thirds of gross investment represents replacement of existing capital stocks.

In the specific case of investment in equipment and software, capital consumption and depreciation charges as a share of gross investment have soared from 74% to 83% from 1997 to 2001.

It is a compelling conclusion that this drag on profit charges is sure to worsen in the foreseeable future, as relentlessly rising depreciation charges on past investment will coincide with weak or falling new investment. While the decline of investment has slowed for the time being, there is nothing in sight that suggests a sustainable reversal in net investment, inherently improving profits.

***It has always been a major theme of this letter that growth in net capital investment is the key determinant of the three conditions that alone make for a nation's growing prosperity. This occurs mainly through three effects: first, by increasing the economy's productive capital stock; second, by increasing profits; and third, by increasing productivity. Significantly, the United States has the lowest rate of net capital formation among the industrial countries.***

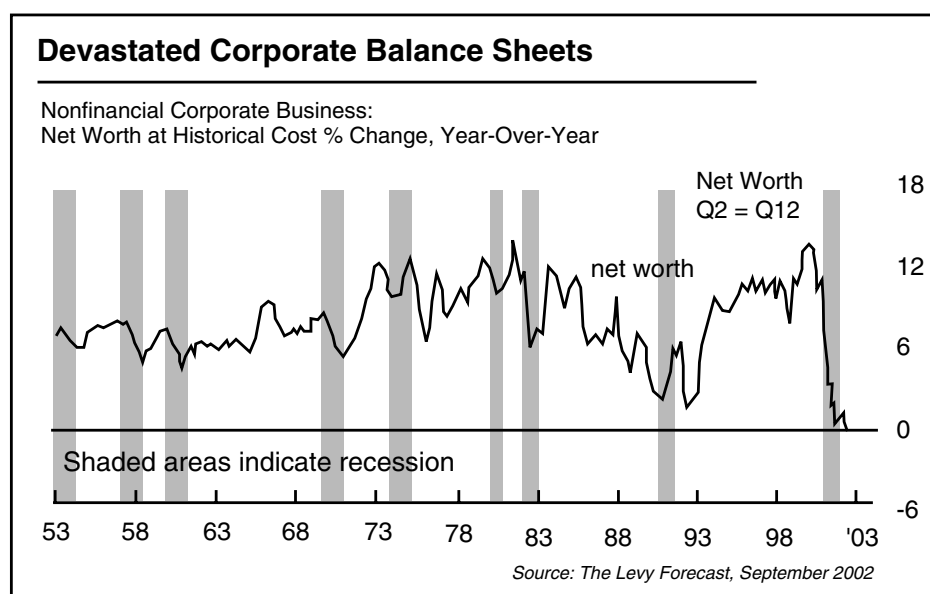
### **...SOARING INTEREST DRAIN**

Looking for the causes behind the U.S. profit implosion, another feature that strikes the eye are soaring interest rate expenses in several sectors. This is in drastic contrast to what happened during the first half of the 1990s, equally a period of economic weakness and low Fed interest rates. The contrast is stunning. What is the reason, or reasons, for this tremendous divergence?

Counting on sharply rising profits, American businesses stampeded into debt with a recklessness that might more appropriately be called outright insanity. Corporate indebtedness has ballooned by more than 50% since 1995, from \$3.1 trillion to \$4.8 trillion. But what made this debt splurge particularly calamitous was the use of its proceeds. Very, very little went into net new investment. Its great bulk went into mergers, acquisitions and stock repurchases, adding nothing to the economy's productive capacity. Huge amounts were virtually dissipated in worthless "goodwill," reflecting absurdly high payments for acquisitions.

As profits went the opposite direction, corporations effectively devastated their balance sheets and credit ratings. The following chart shows the decline of business net worth in the postwar period. Net worth represents the increase in assets at book value minus the inverse in indebtedness. The deterioration in credit quality has been almost unbelievable. Yield spreads above Treasuries for many formerly prime firms have widened by three or more percentage points within weeks. Average junk bonds have been trading at yields of some 10 percentage points above Treasury bonds.

What these and sufficient other data really reveal is that grossly overindebted Corporate America is facing virtually closed doors in the markets for



new financing. On the other hand, it is stuck with record-high interest expenses. For obvious reasons, the Fed's aggressive easing has completely failed to reach corporate finance. Probably, it is tighter than ever.

Back to our earlier observation of the interest drain on profits. For nonfinancial businesses as a whole, interest expenses have surged by 66%. Again, manufacturing stands out as the worst sinner. Its interest bill hit a new peak of \$81.4 billion in 2001, comparing with earnings of \$83.4 billion in the same year. In 1997, interest expenses had accounted for 23% of manufacturing profits; in 2001 for almost 100%.

### **...THE TRADE DEFICIT DRAIN**

Continuing down the list of virulent profit-squeezing influences in the U.S. economy, we come to the one that is least understood. That's the explosion of the U.S. current-account deficit. There is apparently little or no recognition in America that this leakage has played the single most important role in ravaging U.S. business profits since 1997.

For American policymakers and most economists, the gaping U.S. trade deficit is nothing to worry about. To the contrary, they tend to hail it as an emblem of the economy's dynamism. Recently, Mr. Paul O'Neill, the Treasury secretary, discarded it as a "meaningless concept," representing just an "accounting concept," which, by definition, equals the value of net capital flow into the United States and the deficit in the current account. These capital flows, being attracted by the superior rates of return that capital investments in the United States offer, explain everything, according to Mr. O'Neill. According to this concept, the soaring capital inflows create the soaring current-account deficit by driving up the dollar, which, in turn, curbs exports and stimulate imports.

This didn't happen because Mr. Greenspan, with his inordinate monetary looseness, effectively more than offset this massive, external income drag by more and more rampant domestic credit and debt creation.

This statement makes no sense. It is true, of course, that a rising currency tends to have these effects on exports and imports, driving the country's current account into deficit. But this deficit has an evil counterpart in the domestic economy, and that is a corresponding contraction of domestic incomes and demand. With a current-account deficit of 4–5% of GDP, the U.S. economy would have plunged straight into depression.

Intrinsically, the surging U.S. trade deficit is closely related to the gross imbalances in domestic consumption, savings and investment that have accumulated in the U.S. economy over the last few years. In essence it reflects the extraordinary prodigality of the consumer on the one hand versus lousy saving and lousy net investment. Generations of economists of all schools of thought would have lambasted this as the most unhealthy pattern of economic growth.

We have to admit that the dollar's resilience against the horrendous external deficit is the one thing in the American economic and financial development that utterly amazes us. But its obvious reason is that Americans are withdrawing their investments in Europe faster than European investors are withdrawing theirs in the United States. But that can only be temporary. Therefore, we see no reason to change our opinion about its inevitable, coming slump.

***For us, the dollar's prolonged strength, defying dramatically deteriorating news about the U.S. economy and its financial system, is rather the luminous gauge of the still prevailing great illusions about the U.S. economy's health and strength.***

Most shocking for us, though, is the realization that leading American policymakers and the great majority of economists are completely unaware of the fact that the gaping trade deficit has been the U.S. economy's predominant profit killer. In this way, it definitely became a main cause, if not the main cause, of the economy's downturn.

First to the facts. Between 1997–2001, the U.S. economy incurred a cumulative deficit in current account of \$1,428 billion. The annual deficit soared during these four years from \$128.4 billion to \$450 billion at annual rate. These were precisely the years of the great profit plunge. For the consensus, there is no connection between the two. We have again and again stressed that there is a strong, close nexus.

How does the profit squeeze come about through the trade deficit? In short, through diverting current income and spending flows away from domestic producers to foreign producers.

The decisive, critical point to begin with is that all earned incomes ultimately come from business expenses for current production. To the extent that available incomes are spent for the purchase of goods and services from current domestic production, this money returns to the business sector as revenue. In essence, there is a permanent, circular flow from business expenses to incomes to spending and back to business revenues.

But this circular flow gets disrupted when the economy runs a deficit in its foreign trade. It implies that spending on goods and services is to that extent diverted from domestic producers and towards foreign producers. But while the domestic producers thus lose revenue, they remain stuck with their wage expenses. Principally, the trade deficit implements a direct transfer of profits from the United States to the surplus countries. Considering the U.S. trade deficit's monstrous size, it essentially massacred U.S. profits.

The great, new question, of course, is how these various profit-shaping flows will further develop. Checking one after the other, we discern overwhelmingly negative influences.

Of these, two are most important: sharply higher personal saving and sharply lower net investment. Confronted with further savage stock losses, the consumer will step up his saving from current income. Net capital investment, on the other hand, remains exposed to the double whammy of rising depreciation charges and declining gross investment. Last year, the two added up to a savage profit squeeze, slashing business revenues from net nonresidential fixed investment by \$149 billion, from \$437.7 billion to \$288.7 billion.

### **STUPID CAPITALISM**

We have analyzed and described the various causes behind the U.S. economy's unusually dismal profit performance. But we hasten to emphasize that these different negatives for the profit equation are by no means of separate origin. Ultimately, they all have one common denominator, one general cause, that needs to be recognized: that's America's new capitalism with its merger and cost-cutting mania. In its busiest years, 1998 to 2000, deals totaled nearly \$4 trillion — more than in the preceding 30 years.

What we are really witnessing is not just an economic downturn. It is the bankruptcy of America's new capitalism that elevated creating shareholder value to the key performance measure of managerial performance. Eager to please the markets with spectacular actions and quick profit increases, corporate managers vigorously pursued two strategies — cost cutting and mergers and acquisitions.

It is our long-held opinion that what was generally regarded as highly sophisticated microeconomics was in reality very stupid macroeconomics. In the short run, both strategies significantly helped to drive share prices to absurdly high levels, but their effects on the real economy, showing in particular in the dismal investment and profit figures, were destructive.

As the poor profit figures since 1997 show, profits deteriorated even in the short run. Actually, there never was any chance that this capitalism would work as expected because mergers, acquisitions and cost cutting lack the key essential for increasing profits: They don't increase business revenues. To the extent that they curb new investment, which they do, they reduce profits. It is stupid capitalism.

### **THE NEXT JAPAN**

More often than not lately the question is cropping up of whether the U.S. economy could follow Japan into protracted semi-stagnation. In general, this possibility is flatly dismissed. Some seem to find it almost offensive to draw any comparison between the two countries.

For us, answering this question starts with an analysis of the economic and financial maladjustments that the two economies incurred during the boom years. Japan is traditionally a high-investment, high-saving economy. During the boom years of the late 1980s, both business and real estate investment shot through the roof, accounting for more than 30% of GDP. By contrast, personal consumption as a share of GDP fell from

78.6% in 1984 to 75.5% in 1989.

Then, there are the changes in indebtedness, domestic and internationally. All bubbles are essentially debt-driven. With the bubble's spending excesses in Japan centered on capital spending, the borrowing excesses centered on the business sector. For Japan's nonfinancial sector, the debt-to-GDP ratio averaged about 175% over the period 1987 to 1993. It subsequently soared to 235% by 2001. For Japanese private households, the debt-to-GDP ratio rose from just 61% in the early 1980s to 74% in 1989, and further to 77% in 2001.

As explained, the American bubble pattern was the exact mirror image of that of Japan. It had its overriding excess in the borrowing and spending of the consumer. From 1995 to 2001 consumer debt soared from 64% of GDP to 83%. Business borrowing was far less than in Japan, but its pattern was badly skewed towards financial transactions, mergers, acquisitions and stock buybacks. America has one big debt problem that completely eludes Japan. During its bubble years, Japan continued to run a substantial surplus in its current account. The United States, by contrast, ran an ever-widening current-account deficit.

In essence, Japan and America suffer from exactly opposite structural maladjustments. Japan's key structural problem is the failure of the business sector to match available domestic savings with sufficient investment spending. The government's attempts to fill the gap between the two with government borrowing and spending have miserably failed. More or less, this is the main problem of most countries.

The United States is the great exception from this global structural problem. It boosted economic growth by getting rid of saving. This unsustainable pattern of demand has developed over 5–6 years. Taking all the other serious distortions in the economy and in particular the profit carnage into account, we see a very high probability that the United States will be the next Japan.

## **CONCLUSIONS:**

The world economy is caught in a general profit and investment depression. The preponderant, single hope is that further interest rate cuts by the Federal Reserve will, after all, tip the balance and lay the foundation for a sustained recovery of the U.S. economy and its stock market, pulling the rest of the world with it.

Tracking economic data and the developments in the economy and the financial markets, both stocks and credit, we see nothing but aggravating conditions. Renewed drastic weakness of the U.S. economy is the great shock waiting to happen for the world.

A slumping dollar will turn it into a nightmare.

## **THE RICHBÄCHER LETTER**

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